DOCKET FILE COPY ORIGINAL

RECEIVED

DEC 1 0 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	))))	CC Dkt. No. 93-251

COMMENTS OF AMERITECH

John T. Lenahan
Barbara J. Kern

Attorneys for Ameritech

2000 West Ameritech Center Drive
Room 4H88
Hoffman Estates, IL 60196-1025
(708) 248-6077

Date: December 10, 1993

No. of Copies rec'd 2+9
List A B C D E

SUMMARY

As outlined below, Ameritech opposes the changes proposed in the NPRM because the Commission has failed to provide any reasoned analysis that the current cost allocation and affiliate transaction rules do not meet the Commission's goals of ensuring just and reasonable rates, and that the proposed rules will more effectively and more efficiently meet those goals. In this regard, Ameritech opposes the proposed changes because they impose significant administrative and cost burdens while not providing any countervailing public interest benefits. Therefore, the proposed rules would actually be detrimental to the public interest.

Table Of Contents

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	))))	CC Dkt. No. 93-251

COMMENTS OF AMERITECH

The Ameritech Operating Companies (Ameritech),[1] pursuant to §§1.415 and 1.419 of the Federal Communications Commission's rules, 47 C.F.R. §§ 1.415 and 1.419, respectfully submit the following comments, pursuant to the Commission's release of a Notice of Proposed Rulemaking (NPRM) seeking comment on a proposal to significantly change the current cost allocation and affiliate transaction rules.[2] As outlined below, Ameritech opposes the changes proposed in the NPRM because the Commission has failed to provide any reasoned analysis that the current cost allocation and affiliate transaction rules do not meet the Commission's goals of ensuring just and reasonable rates, and that the proposed rules will more effectively and more efficiently meet those goals. In this regard, Ameritech opposes the proposed changes because they impose significant administrative and cost burdens while not providing any countervailing public interest benefits. Therefore, the proposed rules would actually be detrimental to the public interest.

---

[1] The Ameritech Operating Companies are: Illinois Bell Telephone Company, Indiana Bell Telephone Co., Inc., Michigan Bell Telephone Company, The Ohio Bell Telephone Company, and Wisconsin Bell, Inc.

[2] Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and their Nonregulated Affiliates, CC Dkt. No. 93-251, FCC 93-453, 8 FCC Rcd. (released October 20, 1993) (NPRM).

I. Introduction

The Commission established the cost allocation and affiliate transaction rules in 1986 in the Joint Cost Order,[3] as a complement to its Computer III decision allowing carriers to provide both regulated and nonregulated activities in a single entity.[4] In the Joint Cost Order, the Commission stated that its goal in adopting these rules was to ensure just and reasonable interstate rates. The Commission noted, however, that ensuring just and reasonable rates was not limited to preventing cross subsidy but also entailed ensuring that ratepayers participated in the economies of scale and scope that can be achieved through the integration of regulated and nonregulated activities.[5] It was with these goals in mind that the Commission established its cost allocation and affiliate transaction rules.

The Commission's current cost allocation and affiliate transaction rules provide two different rules for determining the value of transactions between regulated and nonregulated activities. There is one rule for asset transfers and one rule for service transactions.[6] Briefly, for asset transfers between a carrier and an affiliate, the asset transfer must be recorded on the books of the carrier at either: 1) the tariffed rate; 2) the prevailing company price if substantial quantities are sold to third parties; or 3) the lower of net book cost or estimated

---

[3] Separation of Cost of Regulated Telephone Service from Costs of Nonregulated Activities, and Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to Provide for Nonregulated Activities and to Provide for Transactions Between Telephone Companies and Their Affiliates, CC Dkt No. 86-111, 2 FCC Rcd. 1298, 1303 -04 ¶ 37-41, (Joint Cost Order) *recon.*, 2 FCC Rcd. 6283 (1987) (Joint Cost Reconsideration Order).

[4] Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I Local Exchange Company Safeguards, CC Dkt. No. 90-623, 6 FCC Rcd. 7571, 7574-75 (1991) (Computer III).

[5] Joint Cost Order at ¶ 109.

[6] See, 47 C.F.R. §§ 32.27 and 64.901.

fair market value if the carrier purchases the asset from an affiliate, and at the higher of net book cost or estimated fair market value if the carrier sells the asset to an affiliate.[7] And, for service transactions, the service transaction must be recorded on the books of the carrier at either: 1) the tariffed rate; 2) the prevailing company price if substantial quantities of that same service are sold to unaffiliated third parties; or 3) the fully distributed cost of that service.[8]

In the NPRM, the Commission proposes significant changes to these rules. At the outset, the Commission notes that the need for cost allocation and affiliate transaction rules derives from the fact that these transactions do not occur at arm's length. The Commission also restates from the Joint Cost Order that the goals of the cost allocation and affiliate transaction rules are to ensure carriers' interstate tariffed rates are just and reasonable by prohibiting improper cross subsidization between regulated and nonregulated activities.[9]

While the Commission never states that the current cost allocation and affiliate transaction rules do not effectively protect ratepayers, in the NPRM the Commission speculates that the "present mix of valuation methods [i.e., tariff, prevailing price, estimated fair market value, and fully distributed cost] may not be optimal for protecting ratepayers against cross subsidization."[10] Specifically, the Commission surmises that, because affiliate transactions are not arm's length transactions, a cost based valuation method, such as fully distributed cost, may not produce "reasonable results in all circumstances."[11] And, in order to

---

[7] Id. at § 32.27(b).

[8] Id. at § 32.27(d).

[9] NPRM at ¶ 3-4.

[10] Id. at ¶ 9.

[11] Id. at ¶ 11.

produce reasonable results in all circumstances, the Commission finds that it must modify its rules.

The Commission proposes two major modifications to its rules. First, it proposes to severely limit the use of prevailing company price and second, it proposes to adopt a new estimated fair market value/fully distributed cost valuation method for service transactions. In explaining the proposal to limit the use of prevailing company price, the Commission contends that affiliates generally fall into two categories: one whose primary or predominant purpose is to support the carriers, and the other whose predominant purpose is not to support the carriers. The Commission then proposes to establish a "bright line" test to determine whether the affiliate's primary purpose is to support the carrier. Specifically, the Commission submits that any affiliate which does not sell at least 75 percent of its output to third parties would be defined as having a predominant purpose of supporting the carriers. Based on this bright line test, the Commission then proposes to limit the use of prevailing company price to **only** those affiliates whose primary purpose is not to support the carrier, i.e., those affiliates which sell at least 75 percent of their total output to third parties.[12]

Even after limiting the use of prevailing price to specific affiliates, the Commission seeks comment on whether to impose additional limitations on the use of the prevailing price. While the Commission agrees that the total company output restriction would protect against "most potential abuse cases," the Commission requests comments on whether to further restrict the use of prevailing price to the sale of only those lines of business or individual products in which the affiliate sells at least 25 percent of the line of business or product to third parties.[13]

---

[12] Id. at ¶ 22.

[13] Id. at ¶ 89.

The Commission also proposes dramatic changes to the fully distributed cost valuation method used for service transactions. Specifically, the Commission proposes to establish a new standard to determine the value of those service transactions which do not meet the tariffed rate or prevailing price standards. The proposed rule is that carriers must record these service transactions "at the higher of fully distributed costs and estimated fair market value when a carrier is the seller, and at the lower of fully distributed costs and estimated fair market value when a carrier is the purchaser."[14]

The Commission argues that the proposed changes in the rules are necessary because under price caps LECs continue to have a sharing obligation which, theoretically, give LECs incentives to pay more than the estimated fair market value for affiliate transactions in order to avoid sharing with ratepayers. Specifically, the Commission contends that, as a means to undermine the sharing obligation, carriers may be motivated to sell their services to affiliates at less than estimated fair market value and, correspondingly, may be motivated to buy services from affiliates at more than estimated fair market value. If LECs act on that incentive, the Commission contends, they are then acting imprudently and therefore their tariffed rates may not be just and reasonable. Thus, the Commission concludes that the incentives promoted by its cost allocation and affiliate transactions rules are at odds with the incentives promoted by price caps, i.e., lower costs and increased carrier efficiency.[15]

However, as explained below, the Commission should not adopt the proposed rules. First, significant developments in the telecommunications

---

[14] Id. at ¶ 34.

[15] Id. at ¶ 32. In addition to these changes in the methods of valuing affiliate transactions, the Commission proposes other changes to the cost allocation rules, including changes involving the calculation of a return component, the calculation of the rate base for affiliates, and changes to the audit procedures. In Section III, Ameritech comments on some of these additional issues.

industry -- price caps, increasing competition, and Computer III -- provide more than sufficient protection against cross subsidy and more than sufficient incentives for LECs to decrease expenses. These developments together with the current cost allocation and affiliate transaction rules ensure that rates will be just and reasonable. Second, the proposed rules would impose a costly and cumbersome regulatory process and would eliminate many of the efficiencies and economies of scale presently available under the current rules. Thus, when the Commission balances the costs imposed by its proposed rules against the fact that its current rules already meet its goals, the Commission should easily conclude that it is in the public interest to maintain its current rules.

II. The Commission Should Not Adopt the Proposed Rules.

As noted above, the Commission is prompted to propose these changes in order to more fully motivate carriers to act efficiently. Nevertheless, before departing from the current cost allocation and affiliate transaction rules, the Commission must be able to explain the benefits to be derived from its proposed rules, and how these proposed changes are consistent with its current regulatory policies.[16] However, the Commission does not fashion such a justification. As more fully explained below, the rules proposed in the NPRM would impose a regulatory framework more onerous and complex than the current affiliate transaction rules at a time when there is need for less regulation, and a need for a more productive environment in which to do business. Moreover, the proposed rules do not provide any additional public interest benefits not presently

[16] Graphic Communications International Union, Local 554 v. Salem-Gravure Division of World Color Press, 843 F.2d 1490, 1493 (D.C. Cir. 1988). That court found that "agency decisions that depart from established precedent without a reasoned explanation will be vacated as arbitrary and capricious." Accord International Union, UAW v. General Dynamics Land Systems Division, 815 F.2d 1570, 1578-79 (D.C. Cir. 1987).

available under the current rules and, in fact, would be detrimental to the public interest.

A. The Commission's proposed rules are contrary to the Commission's procompetitive and streamlined regulatory policies.

In the NPRM, based on a theoretical argument that carriers may buy or sell services for more/less than their estimated fair market value, the Commission proposes to impose onerous accounting requirements for those transactions which occur between regulated and nonregulated operations. These requirements necessitate LECs to perform a market analysis on each of these affiliate transactions before completing it.

The Commission's theoretical argument, however, fails to recognize the myriad developments in the telecommunications industry, including several of the Commission's own initiatives, which give LECs strong incentives to decrease costs, increase productivity, and avoid cross subsidization. Foremost among these developments is the implementation of price cap regulation. Price cap regulation places a 'cap' on the prices carriers charge for services, and in turn, allows carriers to keep profits over and above the targeted rate of return. Thus, price cap LECs have an overarching incentive to decrease costs and increase productivity in order to keep increased profits.[17] Moreover, under price caps LECs have disincentives to cross subsidize since any increase in costs for services will not lead to increased prices or revenues.

While the Commission pays lip service to the incentives promoted by price caps, the Commission by proposing such draconian accounting requirements in actuality disregards the significant impact price caps have had on LECs' actions. For example, since the implementation of price caps in 1990, Ameritech has

[17] Policy and Rules Concerning Rates for Dominant Carriers, CC Dkt. No. 87-313, 5 FCC Rcd. 6786 (1990) (LEC Price Cap Order).

decreased its work force by a total of approximately 4500 people.[18] Correspondingly, total operating expenses decreased in 1992 as compared to 1991, while a commonly used productivity measure, the customer lines per operating company employee, increased from 234 in 1990, to 250 in 1991, to 267 in 1992.[19] Finally, the fact that Ameritech prices many of its access services below the cap is further evidence of the effectiveness of price caps. Meanwhile, other price cap LECs have initiated similar downsizing and expense reduction efforts.[20] Clearly, there is concrete evidence that price caps have worked to decreases costs to the ratepayer thereby maintaining just and reasonable rates.

Although price caps and competition provide more than sufficient incentives to decrease expenses, to the extent the Commission perceives sharing to create improper incentives, the elimination of sharing would solve these problems. At a minimum, the Commission should wait until the completion of the price cap review process, scheduled to begin in January, 1994, before adopting these rule changes. Since the price cap review proceeding will specifically address the question of whether to continue with sharing, it would be premature to impose the substantial administrative and cost burdens on LECs embodied in these rules, when in a few months the justification for those rules may be eliminated.

A second development which obviates the need for the proposed rule changes is the increasing amount of competition for LEC regulated services. In order to cross subsidize, LECs must be able to shift costs from their nonregulated

---

[18] 1992 Ameritech Investor Fact Book.

[19] 1992 Ameritech Investor Fact Book.

[20] In just this last year four large carriers have announced employee reductions. See e.g., Denver Post, September 18, 1993, Sec. A p. 1 (US West to Slice 9,000 Employees Over the Next Three Years); Kansas City Business Journal, September 17, 1992, Vo. II, No. 52, Sec. 1 p. 4 (Sprint to decrease by 1,000 employees by year end, and Southwestern Bell to decrease by 1500 employees over the next 18 to 24 months); and Associated Press, March 9, 1993, Business News (GTE offered early retirement and severance package to 26,000 employees).

activities to their regulated activities. LECs also must be able to incorporate those costs into their rates and maintain a customer base with those higher rates. However, as competition for regulated services increases, LECs are unable to incorporate those expenses into their rates or maintain customers at those prices.[21] Thus, competition for LEC regulated services acts as a constraint on the prices for LEC services, and drives LECs to decrease their costs. And, as the following examples demonstrate, competition will only intensify in the future.

Specifically, pursuant to the Commission's interconnection orders, CAPs, interexchange carriers, and other interested parties are permitted to terminate their own switched and special access transmission facilities at LEC locations, including central offices, service wire centers, tandem switches and certain remote nodes.[22] Since special access transport interconnection became available in June, 1993, Ameritech has received more than 45 bona fide requests for interconnection in 38 different locations. When switched access interconnection becomes effective in February, 1994, Ameritech anticipates a similar amount of interest. Consequently, as of February, 1994, LECs' interstate transport services -- a major portion of their interstate access services -- will be competing with the transport services of CAPs and facilities-based interexchange carriers both of which already own transport facilities.

Moreover, LECs face significant competition from competitive access providers (CAPs) and large and small interexchange carriers in other service

---

[21] For a discussion of the ability and incentive to cross subsidize see Ameritech's Reply Comments on Customers First: Ameritech's Advanced Universal Access Plan, filed July 12, 1993, Attachment H, Effective Competition, Cross-Subsidization and Changes to the Price Cap Rules, NERA Study, p. 7-10.

[22] See e.g., Expanded Interconnection with Local Telephone Company Facilities, CC Dkt. No. 91-141, Transport , Phases I and II, FCC 93-379, 8 FCC Rcd. (released September 2, 1993).

areas, including high capacity business services, and intraLATA toll services.[23] For example, on November 23, 1993, MCI Communications, Inc. announced that it is teaming with Jones Lightwave Cable, Inc. and Scientific-Atlanta, Inc. to offer local and long distance telephone services, and cable TV service from a single source. The team will offer these services in Chicago, IL and Alexandria, VA.[24] On November 12, 1993, MFS Communications Co. filed a petition with the Illinois Commerce Commission to become a local exchange company in the Chicago area, competing with Illinois Bell. MFS requested that the Illinois Commission act on the petition within six months of its filing. And, in November, 1993, Ameritech and Teleport announced that they had neared completion of a technical trial to demonstrate the feasibility of interconnecting their respective local switched telecommunications networks.[25] Clearly, the vigor of competition in telecommunications dictates that LECs act efficiently and in a cost effective manner and eliminates any benefit from cross subsidy.

Finally, a third development is the Commission's removal of the separate subsidiary requirements for the provision of enhanced services and customer premises equipment by LECs. The Commission replaced the separate subsidiary requirements with a regime of open network architecture (ONA) and other

---

[23] See for example, Attachments to Ameritech's Customers First Plan, filed with the Commission on April 1, 1993, which provides substantial information about the amount of competition and the number of competitors in metropolitan areas in Ameritech's region. Supplemental Materials to Ameritech's Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, Attachment 1 of 4, Volume 2, Appendix H, High Capacity Services in the Ameritech Region, and Attachments to Ameritech's Reply Comments, filed July 12, 1993, Attachment C, Ameritech IntraLATA Toll Revenues.

[24] Telecommunications Reports, November 22, 1993, p. 49.

[25] As further evidence of the growth of competition, earlier this year Ameritech filed its Customers First Plan in which it proposes to unbundle its local exchange services and allow integration of other certified competitor's switches into its own public network. This plan will allow competition at every level of industry services.

accounting and nonstructural safeguards.[26] In support of the removal of structural separations, the Commission balanced the public interest benefits resulting from the nonstructural safeguards through increased efficiency and use of economies of scale with a potential increase in the risk of cross subsidization. The Commission expressly found that its existing cost accounting safeguards, as modified in the order, would permit realization of significant public interest benefits while constituting a reliable alternative to structural separations.[27] Thus, as recently as 1991, the Commission found that its current cost allocation and affiliate transaction rules met the Commission's goals to protect against cross subsidy thereby ensuring just and reasonable rates. There is nothing in either the NPRM or other Commission proceedings in which the Commission found or even indicated that the current rules were not adequately protecting the ratepayer.

Based on the foregoing, significant developments in the last few years provide LECs with overwhelming incentives to act efficiently and effectively if they intend on continuing to participate in the telecommunications industry. Price caps, increasing competition and Computer III provide the necessary incentives to LECs to decrease expenses and increase productivity, and disincents them to cross subsidize. In fact, most of Ameritech's rates for interstate access services are priced below the cap demonstrating the impact of competition on LECs' prices. Thus, these developments, together with the recently affirmed cost allocation and affiliate rules ensure that rates are just and reasonable. Moreover, pursuant to these developments the telecommunications industry is clearly moving toward an open marketplace whereby competitive

---

[26] Computer III, supra. note 4, at 7574-75.

[27] Id. at 7577.

forces, not regulatory constraints, will be the driving forces to ensure just and reasonable rates. Consequently, the Commission's proposed rule changes which would substantially increase the burdens of engaging in affiliate transactions is diametrically opposed to the Commission's current policies to streamline regulation and use competitive forces to ensure just and reasonable rates, and understates the effect those policies have had upon the industry.

B. The Commission's proposed rules will not meet the Commission's goals more effectively than the current rules.

While the Commission is not required to keep its cost allocation and affiliate transaction rules indefinitely and has the power to tailor its rules to meet the developments in the industry, it must be able to demonstrate that the proposed changes will more effectively and efficiently meet the Commission's goals. However, as more fully explained below, the proposed rules would impose a significantly more complex and costly regulatory framework without providing any additional benefits.

1. The need to determine fair market value for essentially every service transaction imposes significant costs without providing any countervailing benefits.

In the NPRM, the Commission proposes to require carriers to charge the higher or lower of estimated fair market value or fully distributed costs, based on whether the carrier is the purchaser or seller of the service. The definition of estimated fair market value is generally accepted to be: the price at which a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts, complete a transaction.[28] Since most of Ameritech's affiliate transactions are recorded at fully distributed costs, the proposal would require Ameritech to calculate a

---

[28] See Pratt, Valuing A Business p. 22-23 (2nd. Ed. 1989); accord, United States v. Cartwright, 411 U.S. 546 (1973).

estimated fair markc: value for each of the approximately two hundred service transactions in which it engages.[29]

In order to determine a reasonable measure of estimated fair market value and to comply with the proposed rules, LECs will have to implement a system of competitive bidding (commonly known as request for proposals or RFPs), benchmarking, appraisals or market surveys.[30] Specifically, LECs will have to establish an internal group to perform and coordinate the estimated fair market value analyses, including such tasks as writing up the RFPs, reviewing any responses to the RFPs as well as analyzing those responses to ensure comparability between them. Upon completion of the analyses, the group will have to inform the appropriate parties of the regulated costs of the transaction and ensure that those are the costs recorded in the accounts of the carrier.[31]

Moreover, competitive bidding will not be the appropriate methodology for all service transactions. For example, Ameritech's service organization, Ameritech Services, Inc. (ASI), performs certain network planning, network procurement, and network management functions on behalf of its affiliated operating companies. Because of the competitively sensitive and proprietary nature of those functions, it is unlikely and inappropriate for Ameritech to entertain open bids for those functions. In those situations, some type of benchmarking system which compares similar functions in other companies would have to be used to calculate estimated fair market value. However, such

---

[29] See Ameritech Operating Companies Part 64 Cost Allocation Manual, V. Transactions With Affiliates.

[30] Joint Cost Order, supra note 3, at ¶ 295 note 469.

[31] In addition to establishing an internal group to administer the estimated fair market value analysis function, the new rules would required Ameritech to change its billing systems, affiliate transaction checklist, and ARMIS reports. It would also significantly increase the time and expense of the annual independent Part 64 audit.

benchmarking systems are not necessarily reliable because most companies are reluctant to release competitively sensitive and proprietary information concerning their businesses to third parties.

A similar problem of reliability arises with the calculation of estimated fair market value using RFPs. In this regard, the methodology used to implement and administer the RFP process, as well as the time and money devoted to it, will greatly impact the accuracy of the analysis. In fact, the Commission itself acknowledged the difficulty and subjective nature of obtaining estimated fair market value information, and rejected its use a number of times. In the Joint Cost Reconsideration Order, the Commission rejected several parties' arguments that estimated fair market value should be used to establish the cost of affiliate transactions. The Commission found that the valuation of services should be at fully distributed cost as "essential to the integrity of its cost allocation rules."[32] Moreover, the Commission stated explicitly that "such a valuation standard is fraught with the potential for abuse and would be difficult to monitor."[33] Likewise, the Commission also rejected an argument by Centel that the Commission should allow carriers to record on their books the value of services purchased from affiliates at the lowest bid received in the competitive bidding process.[34] Centel also proposed a number of safeguards for conducting the competitive bidding process in order to ensure the objectivity of the bidding

---

32 Joint Cost Reconsideration Order at ¶ 130.

33 Id. at ¶ 131.

34 Centel Corporation, Petition for Clarification of Section 32.27(d) of the Commission's Rules Governing the Valuation of Services Provided to a Telephone Carrier by an Affiliated Company, AAD 8-1921, 4 FCC Rcd. 2241 (1989).

process.[35] Nevertheless, the Commission rejected Centel's proposal and found that

> In our view, Centel has not demonstrated that a competitive bidding process will consistently produce a market rate for the service that is adequate for our cost allocation purposes...[and that] Centel's proposed safeguards do not provide adequate assurance that the bidding process will consistently yield a fair "market price."[36]

Despite having made those findings, the Commission now wants to adopt 'estimated fair market value' as a reliable method to determine the value and the price of certain affiliated transactions. The Commission, however, has failed to explain what has caused its change of heart. In fact, after reciting specific problems with the competitive bidding process, as well as rejecting Centel's proposed safeguards to that process, the Commission now fails to even suggest how LECs are to determine the estimated fair market value. Even though the Commission proposes to use the estimated fair market value **only if** it is less than fully distributed costs, that does not lay to rest the concerns about obtaining a reliable measure of that value. Specifically, if the estimated fair market value of the service is not reliable, it is not reliable regardless of its comparison to the fully distributed costs of the service. In the NPRM, the Commission provides no new evidence or facts that the estimated fair market value measure would be either easier to obtain or more reliable to justify its use in the future. Clearly it would be arbitrary and capricious for the Commission to impose a costly and burdensome regulatory process when the reliability of the standard is suspect.

---

[35] Centel's proposed safeguards were: 1) that the carrier must solicit bids from a minimum number of unaffiliated service providers; 2) that the affiliate bidder be required to submit a bid without the benefit of information regarding others bids; and 3) that even if the carrier chose the affiliate's bid, it be required to book the lowest bid price. Id. at ¶ 8.

[36] Id. at ¶¶ 17-18.

Nor can the Commission rely on its current use of estimated fair market value for asset transfers to justify the expansion of that standard to services. In the first place, the Commission's use of that standard was premised on the fact that assets are unique items which carry investment risk and which may or may not appreciate in value.[37] Services, on the other hand, are not physical items that have investment risk or which may increase in value. In the second place, in the Joint Cost Reconsideration Order, the Commission established the use of estimated fair market value as a "residual rule," and expected it would be used in only a limited number of cases.[38] However, under the proposed rules, the estimated fair market value/fully distributed cost standard would become the primary method for determining the value of affiliate transactions. Thus, the Commission has taken a position contrary to earlier positions without explanation.

A further complication in ascertaining a reliable measure for estimated fair market value is the implication in the NPRM that LECs would be required to book the lowest amount of estimated fair market value. However, the lowest price is not necessarily the best measure of value. In this regard, different bids may reflect differing assumptions regarding the quality of equipment used, time frames in which work may be completed, as well as intangible benefits of working with an affiliate or nonaffiliate with which one has a long standing relationship and an understanding of each party's needs and requirements. While any estimated fair market analyses would attempt to make each bid comparable, the practical reality is that it will be nearly impossible to do it.

---

[37] Joint Cost Order at ¶ 295.

[38] Joint Cost Reconsideration Order at ¶ 118.

Finally, the implementation of the proposed rules will result not only in increased costs to the carrier but also in loss of efficiencies and economies of scale available under the current rules. Based on a review of Ameritech's Cost Allocation Manual (CAM), most service transactions are generally of two types. One type is an infrequent service transaction involving the use of a loaned employee or the division of an affiliate or carrier providing support for a specific project for a limited duration of time. The other type of service transaction is a ongoing relationship in which an affiliate performs work on behalf of the LEC.

The first type of service transaction is an efficient and cost effective use of the entire corporation's resources because of the employee's or department's knowledge and familiarity with the affiliate's or LEC's policies and systems. Under this type of arrangement, the job is done quickly and effectively. However, if the costs of calculating an estimated fair market value are imposed on such a transaction, it is unlikely it would be cost effective.

Likewise, the second type of service transaction is efficient because these service organizations already decrease costs to LECs by consolidating job functions and eliminating affiliated LECs' need to duplicate them. For example, Ameritech Services, Inc. (ASI), the service organization owned by the Ameritech operating companies, performs most of the support and administrative functions related to interstate access services for the operating companies. These functions include federal regulatory, marketing and account management, and network design and procurement, thereby saving each of the Ameritech operating companies the need to establish their own departments to perform this work. It is the efficiencies and cost savings available through these types of affiliate transactions -- which are completed at fully distributed cost -- that provide ratepayers substantial benefits through economic efficiency.[39]

However, under the Commission's proposed rules, LECs would lose the efficiency and economies of scale benefits emanating from these service organizations. Specifically, LECs may be driven to move many of these consolidated functions into the operating companies in order to ensure recovery of the fully distributed costs under § 64.901 of the Commission's rules,[40] or to avoid the added expense of determining an estimated fair market value of each affiliate transaction. Under those circumstances, ratepayers would no longer enjoy the economies of scope and scale that the Commission originally sought to promote through its affiliate transaction and cost allocation rules. Rather, in order to keep any efficiencies, the consolidated work functions would be incorporated into one operating company which would then have to bill its affiliated carriers for the services provided.[41] Thus, the Commission's proposed rules directly conflict with the Commission's earlier decision that the cost allocation and affiliate transaction rules should not impact the organizational structure of the carriers.[42]

---

[39] In fact, for those organizations which provide support services exclusively to their affiliated carriers, there is no concern for cross subsidy. Since all costs are billed to the carriers, the fully distributed cost allocation ensures that each activity covers its costs.

[40] While Ameritech does not believe that the estimated fair market value of the services provided by affiliates will be greater than the fully distributed costs, without any indication from the Commission as to how that estimated fair market value will be determined, Ameritech cannot assume that will be the case. As noted above, the methodology used to calculate the estimated fair market value will greatly impact its accuracy, and implementation costs.

[41] Such an arrangement would throw just more complexity into the state jurisdictions as each state commission reviewed the billings from the one operating company to its affiliated operating companies.

[42] NPRM at ¶ 42.

Clearly, the Commission's proposed rules to require both a estimated fair market value and fully distributed cost analysis will impose significant cost and administrative burdens on LECs. LECs, and to some extent ratepayers, will bear the burden of increased costs to implement the system and experience a definite loss of efficiencies. Moreover, as noted above, there will be substantial questions from both the Commission and competitors about the reliability of the estimated fair market value analysis. In fact, because the NPRM does not even suggest a method to use in determining the estimated fair market value, Ameritech anticipates that there will be additional costs in time, money and effort, resulting from disputes and disagreements about the estimated fair market value procedures and methodologies. Based on these factors, the Commission cannot fashion a reasonable argument supporting the adoption of this rule.

2. The proposed prevailing price rule is illogical.

As noted earlier, the Commission proposes to adopt a bright line test that will limit the use of prevailing company price to only those affiliates which sell at least 75 percent of their output to third parties. The Commission also seeks comment on a proposal to further limit the use of prevailing price to only those services or assets in which the affiliate sells at least 25 percent of the product or line of business to third parties. In support of this limitation, the Commission reasons that an affiliate with at least 75 percent of their output sold to third parties does not have a predominant purpose to support the LECs.

However, the Commission fails to explain how having a predominant purpose to support carriers (even if it can be reasonably defined as less than 75 percent of total output) undermines the reliability of using a prevailing price, derived from the price of sales to third parties, for cost allocation and affiliate transactions. For example, even if the affiliate sells almost all of a particular service or asset to third parties, but does not meet the 75 percent bright line test, the affiliate will not be able to charge the carrier the prevailing price for that service. Such an outcome is irrational. Surely those third party sales provide sufficient evidence of a prevailing price for that service or product regardless of how many other products or services the affiliate sells to its affiliated carriers. In fact, the Commission has already stated that third party sales are more reliable than estimated fair market value for determining the cost of affiliate transactions.[43] In the NPRM, the Commission states that, in instances in which an affiliate does provide the same or similar service to third parties, that price will be assumed to be the estimated fair market value if, and only if, that estimated fair market value is below the fully distributed costs.[44] Again, it is entirely illogical that sales to third parties, i.e., prevailing price, are sufficient evidence of a estimated fair market value, but only under certain circumstances. If sales to third parties, i.e., prevailing price, are sufficient evidence of estimated fair market value, they should be sufficient evidence regardless of how they compare to fully distributed costs.

Because of the inherent inconsistency with the proposed rule, the Commission should reject the bright line test. Rather, the Commission should maintain its current rule requiring that there be substantial sales to third parties before affiliates may use prevailing price. In this regard, Ameritech uses more than one factor in determining whether there have been substantial sales. Specifically, Ameritech considers both the amount of revenues sold to third parties as well as the number of third party customers in determining whether using prevailing price is appropriate. A test looking at both revenues and the number of customers does not rely on a single criteria and therefore is a better

---

[43] See Centel Order at ¶ 17, and Joint Cost Reconsideration Order at ¶ 131.

[44] See NPRM at ¶ 92.

measure of the outside market. Moreover, the use of prevailing price is monitored through the annual compliance audit during which nonregulated affiliates are required to provide evidence of third party sales to demonstrate the validity of that price.

3. The Commission's current rules provide substantial protection against cross subsidization.

There is substantial evidence that the current cost allocation and affiliate transaction rules fulfill the Commission's goals of ensuring just and reasonable rates. In this regard, in Computer III, the Commission recently affirmed that its current cost allocation and affiliate transaction rules permit the realization of the public interest benefits of integrated provision by the LECs of basic and enhanced services without creating substantial risks of cross subsidization in comparison to structural separation.[45] In addition, the Commission noted that other accounting safeguards such as the filing of cost allocation manuals, the requirement that carriers submit to independent audits, and the establishment of ARMIS work together with the cost allocation and affiliate transaction rules to disincent LECs from cross subsidizing.[46]

Moreover, there is a dearth of evidence demonstrating that the Commission's current cost allocation and affiliate transaction rules have not provided effective and efficient protection against cross subsidization. The Commission can cite to no finding that any affiliate transaction which followed the established rules resulted in unjust and unreasonable rates, or was found to be imprudent.[47]

---

[45] Computer III at 7577 ¶ 13.

[46] Id. at ¶ 14.

[47] There have been a few incidents in which carrier shave been found to have violated the Commission's affiliate transaction rules, however, those findings are not relevant to the issues raised in the NPRM because the NPRM implies that the current rules, even if followed, are not sufficient to protect the ratepayer.

While the Commission appears to change the objectives of the affiliate transaction rules in the NPRM from ensuring just and reasonable rates to protecting the ratepayer from carrier 'imprudence'; the proposed rules will not meet this goal. Whether a purchase is prudent is not necessarily answered by the price that is paid for that purchase. Rather, a purchase -- even if it complies with the Commission's proposed rules -- may be imprudent if the carrier has no need for the service or asset. Similarly, a purchase could still be prudent even if its fully distributed cost is greater than the estimated fair market value, if the intangible benefits of having the service provided by a knowledgeable affiliate outweigh the benefit of a lower price. While some parties may argue that these intangible benefits would be reflected in the estimated fair market value, that may not be the case. The practical reality is that such factors may not be included in the estimated fair market value analysis. Thus the implementation of the new rules will not ensure the prudency of the affiliate transaction. Therefore, the Commission should presume that the expenses related to and consistent with the current cost allocation and affiliate transaction rules are reasonable and prudent, and allow LECs the discretion provided by the current rules to decide when to engage in affiliate transactions.[48]

Based on the foregoing, the Commission should reject the proposed rules, and work to streamline its current cost allocation and affiliate transaction rules, due to the substantial protections from competition and industry changes. In the first instance, there are several developments in the telecommunications industry -- price caps, increasing competition and Computer III -- which in and of themselves will ensure just and reasonable rates. Secondly, the proposed rules

---

[48] There is a general presumption that the expenses required by the carrier to operate the business are reasonable and prudent until challenged and found to be exorbitant or incurred in abuse of discretion or in bad faith. See e.g., Mountain States Telephone and Telegraph. Co. v. FCC, 939 F.2d 1021 (D.C. Cir. 1991).